

NESTOA 2015

Transfer Pricing and Intercompany Transactions

Matthew Dayton, Connecticut Department of Revenue

Dr. Elliott Dubin, Multistate Tax Commission

Leah Robinson, Sutherland Asbill & Brennan LLP

Marc Simonetti, Sutherland, Asbill & Brennan LLP

Agenda

- Overview of Transfer Pricing
- State Transfer Pricing Authority
- State Transfer Pricing Adjustments
- Multistate Tax Commission ALAS Project

What is Transfer Pricing?

What is Transfer Pricing?

- Generally, transfer pricing refers to the mechanism used to establish the arm's-length price of transactions between related entities for goods, intangible assets, services, and loans.
- Designed to prevent tax avoidance among related entities by requiring pricing equivalent to prices available with an uncontrolled party.
 - Transactions must (generally) be at arm's length
 - Non-arm's length intercompany transactions can impact the clear reflection of income in states where income is reported on a separate or partial combination basis
 - Tax evasion or avoidance is generally not a pre-requisite for application of § 482 adjustment

What is Transfer Pricing?

- Federal Landscape:

- Codified under IRC § 482
- Extensive regulations, detailed methodologies
- Developed body of judicial decisions
- Disciplined procedures for obtaining advance approval for transfer pricing

Transfer Pricing Authority – Federal Background

- Transfer pricing is governed by IRC § 482 and extensive federal regulations
 - Adjustments permitted among related business if necessary to prevent evasion of taxes or to clearly reflect the income of such businesses
- Language of § 482
 - In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses...

State Transfer Pricing Authority?

State Transfer Pricing Overview

- State landscape varies: Used for –
 - Combination
 - Expense/Income adjustments or reattribution
 - Adjustments to international pricing that IRS “missed”
- Many states have specific statutes that adopt or are substantially similar to § 482.
 - States with § 482 may or may not incorporate the federal regulations promulgated under IRC § 482
- Many states, while not specifically adopting federal § 482 language, have other statutory provisions providing same authority.
- Nearly every state adopts some statutory regime to adjust transfer prices of intercompany transactions.
 - Notable states that do not: Delaware, New Mexico, Pennsylvania

State Transfer Pricing Adjustment Authority

- Some states directly cross reference § 482 in their transfer pricing statutory provisions.
 - *E.g.*, Alabama, Ala. Code § 40-2A-17
 - (a) In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Commissioner of the Alabama Department of Revenue may distribute, apportion, or allocate gross income, deductions, credits, or allowances, if the Commissioner determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of Alabama income taxes or to clearly reflect the income of any such organization, trade, or business.
 - (f) The Commissioner . . . shall exercise such authority in a manner consistent with this act and, to the extent applicable, 26 U.S.C. Section 482 and the rulings and regulations issued thereunder.
 - See *also* Maryland, Md. Code Ann. Tax-Gen. § 10-109; Arkansas, Ark. Code Ann. § 26-51-805.

State Transfer Pricing Adjustment Authority

- Some states adopt the approach to transfer pricing similar to § 482 but make no direct reference to § 482.
 - Connecticut, Conn. Gen. Stat. § 12-226a;
 - If it appears to the Commissioner of Revenue Services that any agreement, understanding or arrangement exists between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or capital of the taxpayer within the state is improperly or inaccurately reflected, the Commissioner . . . may determine, to adjust items of income, deductions and capital, and to eliminate assets in computing any apportionment percentage under this chapter

State Transfer Pricing Adjustment Authority

- Some states assert statutory language broader than federal § 482 authority.
 - *E.g.*, Virginia, Va. Code Ann. § 58.1-446
 - When any corporation liable to taxation . . . conducts the business of such corporation in such manner as either directly or indirectly to benefit the members or stockholders of the corporation . . . by either buying or selling its products or the goods or commodities in which it deals at more or less than a fair price which might be obtained therefor, or when such a corporation sells its products, goods or commodities to another corporation or acquires and disposes of the products, goods or commodities of another corporation in such manner as to create a loss or improper taxable income, and such other corporation . . . controls or is controlled by the corporation liable to taxation under this chapter, the Department may require such facts as it deems necessary for the proper computation provided by this chapter and may for the purpose determine the amount which shall be deemed to be the Virginia taxable income of the business of such corporation for the taxable year . . .

State Transfer Pricing Adjustment Authority

- Some states with no § 482 equivalent (or some lesser authority) nonetheless assert the right to adjust intercompany pricing by asserting general federal conformity or general discretionary powers.
- For example, Maryland asserted this in 1999.
 - *Maryland Comptroller of the Treasury v. Gannett Co. Inc.*, 356 Md. 699 (1999)
 - General federal conformity did not instill in the Comptroller the same discretionary authority granted to the IRS in § 482
 - MD Comptroller had no power to make transfer pricing adjustments in the absence of federal adjustments
 - In 2003, Maryland enacted broader § 482 equivalent power

State Transfer Pricing Adjustments?

State Transfer Pricing Authority – Combined Reporting

- New York historically applied IRC § 482 to determine whether affiliate transactions are distortive, justifying forced combined reporting as well as for when a taxpayer requests to file on a combined basis.
 - In *Hallmark Marketing Corporation*, an administrative law judge ruled that the taxpayer, a marketing company, could not be required by the Division of Taxation to file its 1999 corporate franchise tax report on a combined basis with its parent, a manufacturer of greeting cards.
 - The Tax Appeals Tribunal affirmed, holding that while the words of NYCRR § 6-2.5(a) standing alone might lend themselves to other interpretations, it is clear from the case law that it is necessary to find distortion, and not merely the existence of substantial intercorporate transactions, in order to require the filing of a combined report. *In the Matter of the Petition of Hallmark Marketing Corporation for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Year 1999.*, 819956, 07/19/2007.

State Transfer Pricing Authority – Adjust Income

- Massachusetts used authority to adjust income/expense
 - *IDC Research Inc.* (Mass. ATB 2009)
 - Taxpayer, parent corporation, operated at a loss during audit years.
 - Commissioner imputed additional income to taxpayer pursuant to § 482 authority, asserting prices charged for services were not at arm's-length.
 - Commissioner believed company should “break even” – based all adjustments solely on this belief.
 - Board found Commissioner improperly applied § 482 rules.
 - Proof of arm's-length pricing sufficient;
 - Some activities not the type subject to § 482 rules
 - Commissioner's adjustments based on no substantive or comparative data. Overall expenses not appropriate basis for § 482 adjustments.

State Transfer Pricing Authority – Adjust Income

Use of Third-Party Economists

- District of Columbia
 - D.C. has dealt with transfer pricing issues before.
 - In *Microsoft Corp. v. Office of Tax and Revenue*, the controversial methodology relied upon by several states to assess corporate taxpayers for transfer pricing violations was ruled invalid by a D.C. Administrative Law Judge (ALJ). *Microsoft Corp. v. Office of Tax and Revenue*, 2010-OTR-00012 (2012).
- New Jersey's experience

State Transfer Pricing Authority – Adjust Income

- **Connecticut**
- Prior experiences
- Current projects

Multistate Tax Commission ALAS Project

Arm's-Length Adjustment Service ("ALAS") Project Background

- States recognized that there are significant issues related to transfer pricing at the state level. Many states lack the expertise and resources/flexibility to staff the function.
 - MTC could develop staff with the expertise for a complex subject matter
 - Share cost among interested/affected states
 - States would also benefit from expert case support
- Origin:
 - MTC meeting in D.C. - 2013
 - Other historical discussions with MTC never achieved critical mass
 - MTC Project Facilitator (Dan Bucks) hired in May 2014MTC Executive Committee approved program design on May 7, 2015

ALAS Project Background

- Advisory Group of States (formed in May 2014) were: Alabama, D.C., Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey, and North Carolina
- State's Roles:
 - Funding through supplemental MTC dues
 - Case Nomination
 - Issue Identification
 - Initial document collection and review
 - APAs?
 - Assessment
 - Other End-Stage Case Handling with MTC support

ALAS Program Design

- Two components of MTC Project
 1. Providing / Developing Economic Expertise
 2. Conducting Transfer Pricing Audits
- The Project Committee has identified the following goals of the Program Design:
 1. Training
 2. Transfer Pricing Analysis
 3. Information Exchange, Process Improvement, and Case Assistance
 4. Case Resolution and Litigation Support Services
 5. Optional Joint Audits

What Will it Cost?

- What will the Program cost to the states?
 - Estimated 4-year total cost is \$7,833,000, assuming 10 states join the program.
 - Two general components to the cost:
 - 1. General Services Roughly 1/3 of the cost
 - 2. Transfer Pricing Analysis - 2 additional subsets:
 - Pre-analysis Technical Review
 - Economic Analysis
- Six States have indicated interest –
 - Alabama, Iowa, Kentucky, New Jersey, North Carolina, and Pennsylvania'
 - Hoping to add at least 4 more states to list.

NESTOA 2015

Transfer Pricing and Intercompany Transactions

Matthew Dayton, Connecticut Department of Revenue

Dr. Elliott Dubin, Multistate Tax Commission

Leah Robinson, Sutherland Asbill & Brennan LLP

Marc Simonetti, Sutherland, Asbill & Brennan LLP